

FX ■ Focus

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COMPARING APPLES AND APPLES

With clients expecting more transparency, it is vital for firms to be in control of costs. The key is determining the true all-in price of execution. By **Laura Matthews**



The question that most frequently causes politicians to be labelled 'out of touch' concerns the price of milk. Knowing the cost of basic commodities is seen as the essential ingredient for anyone running a household or a business – it is the very building block of being in control and on top of what is happening in the wider context, and it's a crucial indicator of whether someone really knows their audience.

In foreign exchange, this has not always been the case, but in the rapidly evolving environment that values transparency above all else, the casual observer may expect market participants to have a fairly good grip on costs. And yet, in an industry that has enjoyed decades of growth, in terms of volumes and revenues, the acute change of focus from growth to cost control is proving revealing. In other words, not being able to tell the price of milk, or in this case the overall costs associated with FX, is painfully evident and no longer good enough.

Dealing with the challenge is difficult, with the FX market being so fragmented, and as the interaction between consumers and providers becomes more complex and less clear.

"There isn't that single level playing field,

which would allow a fair and unbiased comparison of costs – a true comparison of apples and apples – so everyone is having to do it in their own little world. That, I think, makes it very difficult," says a senior industry participant. "Obviously, the costs of doing business have increased and there is more of a need to look at your all-in cost of execution, including the costs of balance sheet, capital market impact, etc. But for some of these elements, like measuring slippage, there is no standard and that's tricky."

Then there is the increasing choice of counterparties, venues, execution styles and methods. Five years ago, for example, the concept of an order in FX, in the

context of a client placing one with a bank and the bank working that order as an agent for a commission, did not exist.

"Now you have the situation whereby a client may not be using a bank to trade as principal, but asking their counterparty to act as agent

and execute their order in the market, and we will pay you X per million to do that. That is an explicit cost, which for a lot of market participants is still a very new concept," says the senior industry participant. "Some of these costs are explicit and quite clear. Some of them are implicit and hard to quantify. So the challenge, I think, for the market now is to figure out how they can basically determine what their

true total cost is, and then make the informed decision about who they should trade with and how they should trade."

All of this fragmentation and variety of approach makes measuring costs challenging from both a producer and service provider point of view, as well as from the customer's. Determining your business costs is very different from a market-maker trying to figure out how much it will be to show a price to a client.

Customers have always complained about rising costs, and in the FX world their efforts to demand more for less have been more successful than most. FX clients have enjoyed years of narrowing spreads, free execution of fixing orders and many perks in exchange for taking volumes to providers. This mentality is vanishing, even if at a glacial speed.

A long-standing veteran of FX markets says it is best execution requirements that have put asset managers firmly in the spotlight, as they now need to show asset owners they have made the best possible decision with the best available tools at their disposal and a proper audit trail.

"It is not just the buy side [that] has this much more complex landscape to navigate. It is [the realisation] they have a duty of care to the owners of the assets to achieve best execution," the person adds.

But, while clients have enjoyed a declining cost base and many (seemingly) free lunches, providers have seen their outgoings rocket – a situation that might be viewed as ironic if it were not so difficult.

Regulations such as the Dodd-Frank Act

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Senior industry participant

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and Basel III, where some provisions have forced products on to the sell side's balance sheet that were not there previously, have created a significant amount of extra charges associated with FX, especially for banks.

Nowhere is this more evident than in the FX prime brokerage (PB) space, where the rising expense of capital and events such as the Swiss National Bank's removal of the cap on the franc in January 2015 led market-makers to change their business practices, rendering certain clients and flows more desirable than others in an effort to combat higher expenses and reduce risk.

"Some businesses, especially those where the banks acted in an agency capacity, had always been very balance sheet friendly," says a head of FXPB at a multinational bank. "The fact that futures commission merchants are now required to carry those positions on their balance sheets, applying whatever multiplier is applicable to that asset class, has completely changed the proposition. Items that had incredibly little or absolutely no balance sheet impact are now generating capital charges, with some asset classes more meaningful than others."

Whose turn is it to pay?

There is also the question of end-users being able to distinguish between explicit costs, i.e. spreads, and implicit costs – the inevitability of paying for something which at a glance seems to be free, as proved to be the case with benchmarks.

According to Harpal Sandhu, chief executive officer of trading platform Integral, while the explicit costs of trading may have increased in general, customers are getting better execution today, which has lowered the implicit costs – the cost of actual trading – whether in the spread or in the market moving away from them.

"A very good example of this is in the WM/Reuters process, where five years ago people assumed WM/Reuters was free – 'I don't pay anything'," he says. "And they would have completely overlooked that although there was no explicit cost in trading of WM/Reuters at the midpoint of the fix rate, there was a significant implicit cost in that the mid-rate itself could be moved against the customers."

"Market-makers are clearly being forced to offer better prices than they were before because of that transparency, and customers' market knowledge has led to market-makers charging less for the services they provide," Sandhu adds.

For the sell side, this translates into having to be more selective with clients. As service providers take stock of all their trading costs there has been a shift in attitude towards core

clients mattering more than volumes. This has a ripple effect on customers and counterparts who also need a sharper focus.

"One piece of it is that brokers need to become more of a partner with our providers," says Bryan Seegers, head of eFX pricing and execution at ADS Securities in Abu Dhabi. "The brokers need to be more selective with who they give their liquidity to and who they take liquidity from."

As a result, intermediaries such as ADS are becoming more selective in how they give business to providers and who they will accept business from on the client side to ensure no harm is done to the relationship.

"It means no longer sweeping the book, having the analytics around our flow and being smart enough to say, 'hold on, wait a second', and not just send it to the provider and run them over; to be able to look at the decay of the trade immediately and say, 'that is not good business, based on the pricing being provided, [so] let's get rid of it quickly and move that client to a less aggressive price stream to protect our providers because they no longer have the staff and resources to do this themselves,'" says Seegers. "We are now a partner to them to ensure damage isn't done and, if it is, to mitigate it as soon as possible."

While the emergence of technology is empowering the buy side with the kind of information that allows them to have meaningful conversations with other market participants about costs, some may be entering such talks at a disadvantage.

Capital market professionals at Broadridge Financial Solutions are finding fragmentation within the different parts of the business could be preventing them from benefiting from economies of scale.

"What we see from a cost perspective is that over the last few years, as people have looked to FX as a newer asset class, there has been internal fragmentation within firms when it comes to technology as well as people," says David Campbell, head of capital markets strategy, global technology and operations at Broadridge. "So it's possible a firm could have multiple operational groups dealing with FX and multiple systems dealing with FX – that has led to a definite rise in cost."

He explains that on the revenue and expense management side, many firms have potentially fragmented their FX business internally, meaning they have fragmented relationships with their counterparties and

providers. Consequently, they are not necessarily leveraging their volumes with providers to have the best rate cards.

"A single firm may be dealing with the same provider for the same instruments, but different units are paying radically different prices," Campbell says. "Consolidation in this area, starting with an understanding of the totality of a relationship with a counterparty and its associated costs, can have great benefits. Then, it's a matter of negotiating better deals in terms of being able to get those costs under control."

"We have typically seen that as sort of the third phase of cost for a lot of firms; they look at the people, they look at the

technology, but many of them haven't necessarily gotten to 'what am I paying to the liquidity providers and what am I paying to the counter-parties?' and 'how can I consolidate my agreements with these organisations to get the best deal?'," he adds.

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David Campbell, Broadridge

Objectives matter

So is it possible to have an overall cost that would allow competitors and producers, as well as clients to compare how good they are at managing resources? Phil Weisberg, managing director of Thomson Reuters, thinks such a question is missing the point.

"People immediately go to transaction fees, but I really don't think that is the most important part of the equation. The most important part of the equation is what are you trying to do? It makes a big difference if you say I want to minimise the variance between a benchmark and where I am executing each day, and what I care about is having certainty every day when taken individually. Or I want, on average, to minimise that every day or alternatively I care about absolute return," he says.

In other words, the key to achieving best execution and firm cost control is process – a way of simplifying and focusing on objectives.

"We've been talking about best execution for many years, but now I think we are in a position where a lot of people view best execution as a process, and within that you need to make sure you have the right analytics to help deliver against all of those requirements in that process," the industry veteran concludes. "That is where I think the world is headed. That's a natural consequence of that complexity – you need to simplify it again and help people navigate it."